Financial Sources for Entrepreneurship: Taking Nanjing Pharmaceutical Company as an Example

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Abstract—With the vigorous development of financial market, many financing channels have emerged in the market, which provide diversified capital selection channels for enterprises. Faced with a variety of capital selection channels, enterprises can choose some reasonable and suitable financing models according to their own actual conditions, so as to be used for daily operation and research and development of new projects. This paper described the different sources of funding for the Traditional Chinese Medicine (TCM) project initiated by Nanjing pharmaceutical company (NPC). Firstly, the characteristics and costs of different financial resources are expounded. Secondly, several appropriate modes of TCM financing in NPC are discussed. Finally, through a series of surveys and analyses, combined with some standard formulas, the use of of retained earnings, leases and government assistance for financing was recommended.

Keywords—Financial resources; Retained earnings; Leasing; Government aid

I. INTRODUCTION

Nanjing Pharmaceutical Company (NPC) is a company specialized in the production of chemicals, biological preparation, blood product, Chinese medicine and general medicine equipment. In 2018, the sales revenue of NPC reached 12.8 million RMB, with the market coverage rate is 40% of the national population, controlling over 50% of the national medicine market capacity and over 60% of the total national medicine institutions. It is clearly that the NPC has wide market coverage in China. The company has 12 major distribution centers in six provinces and one autonomous region and serves approximately 46,000 medical clients; including hospitals, wholesalers, pharmacies and others, among which there are 200 level 3 hospitals and 500 level 2 hospitals. However, that the NPC wants to operate the TCM program is still difficult, because cash of the company is limited. Thus, the NPC should use some financial sources to settle the problem. Thus, different financial resources and their cost will be discussing in the report so that some appropriate financing modes will be suggested to the NPC to get the funds for the TCM program.

II. SOURCES OF FINANCE

Funding approach is a specific form which is the way of an enterprise to get the funds, reflecting the properties of money. Generally, there are six kinds of ways for the fund-raising: direct investment, issuing shares, bank loan, commercial credit, issuing bond and leasing [1].

With the rapid development of China's financial market, China's market provides enterprises with a variety of capital options. Enterprises can choose reasonable financing methods according to their actual conditions.

A. Bank loan

The company can borrow the money from the bank to meet the needs. This financial source is simple, because the procedures is simple and the company can get the funds in a short time; moreover, the bank can keep the privacy strictly as well. However, the enterprise need to pay for the fixed interests, if the company can not arrange the repayment of funds reasonably, the deterioration of financial situation of the company will be serious.

B. Issuance of bonds

It is a legal act of the issuer to offer bonds representing certain creditor's rights and payment conditions to investors for the purpose of borrowing and lending funds in accordance with the procedures prescribed by law. Bond issuance is one of the important forms of securities issuance. The act of raising funds in the form of bonds. Through this process, the issuer, as the ultimate debtor, transfers the bonds to its original investors. It is similar to bank loans, but bonds are issued from a wider range of sources.

C. Issue common stock

Common stock is the most basic and important part of a company's capital. It doesn't have to pay principal, it doesn't have to pay dividends at certain times like bank loans and bonds, so it's less risky. And it can improve the credibility of the company. However, its cost of capital is higher. Generally speaking, the stock financing cost is greater than the bond fund, the stock financing request has the higher reward, and the stock must pay from the after-tax profit, and the debt fund interest may deduct before the tax. Additional, the issuing cost of common stock is higher. And this kind of financial method will lead to the dispersion of the original shareholder control.
D. Issuing preference shares

Preference shares have the advantages of both the bonds and ordinary shares. It not only doesn’t have the pressure of paying back the principal, but also the dispersion of original shareholders’ control. However, the cost of the preference shares is higher than the cost of debt both of which are after the taxation. Although the shareholders of the preference shares assume the risk in proportion, they can only get a fixed pay, so the effect of issuing preference shares is not as good as issuing bond.

E. Leasing

Here we talk about the financial leasing which is also called equipment leasing or modern leasing. It is a form of rental. Finance leases are lease agreement between the user of the leased asset (the lessee) and a provider of finance (the lessor) for the main part of the asset’s expected useful life, if not its entire useful life.

F. Government aid

Government aid is free to obtain the monetary assets or non-monetary assets from the government. It does not include the capital which the government is treated as an investor. Generally, if the company asks for the government aid, the government will ask the company to give up some chance to produce some specific products. So the cost of this source of finance is the opportunity costs.

III. THE SOURCES OF FINANCE FOR NPC

A. The principles for managing the financial resources

Although we have many ways for fund-raising, the way we choose the sources of finance is not sightless. Personally, there are two principles for managing the finance resources:

- From the inside to the outside. The company, firstly, should consider the money of its own. If the money is not enough, then the company will get the money by using those sources of finance.
- To minimize the debt. According to the formula:

\[
\text{Capital} = \text{equities} + \text{retained profits} + \text{other reserves} + \text{borrowing}
\]

If the company borrows too much money, it will increase the liability and the non-performing assets [2]. Thus, the company will easily get into the problem which is that when the company is insolvent, she will be bankruptcy.

B. Financial matrix

Except the principles, the NPC has its own characteristics: it is not only a public limited company, but also a state-owned company. So the sources of finance for NPC are more extensive. Personally, to follow these principles and take advantage of the company its own, here three kinds of sources of finance for the NPC’s TCM program are suggested, which are shown in table I.

C. Retained earnings

It is part of profits which is undistributed provides a common means of raising funds from shareholders. The funds belong to shareholders and, if not retained, would be distributed as dividends. There are advantages to using retained earnings as a form of finance: absence of ‘brokerage cost’ (merchant banks’ fees), simplicity and flexibility and all gains from investment will still ultimately belong to existing shareholders. There are, however, disadvantages: shareholders’ expectation of dividends may present a problem and insufficient earnings may be available.

The cost of retained earnings is opportunity cost which is the opportunity loss of distributing the dividends for the shareholders [3]. Because the cost of retained earnings is opportunity cost which is not the actual cost, we can only estimate it. The difficulty of estimating the opportunity cost is to estimate the cost of debt, because it is difficult for the company to make an accurate determination of the prospects of the future development of business and the future risk of the future development of business and the future risk of risk premium required by shareholders. There are many ways to calculate the cost of retained earnings, mainly the following three ways:

- Growth of dividend model

Calculating the cost of retained earnings is based on the investment returned rate of stock increasing continuously. Generally, assuming the earnings are increasing as a fixed annual growth rate [4], then the formula for calculating the cost of retained earnings as follow:

\[
K_s = \frac{D_c}{P_c} + G
\]

Ks: the cost of retained earnings
Dc: the expected annual dividends
Pc: the price of ordinary shares
G: the annual growth rate of ordinary shares

For example, the price of ordinary shares of the company is 56RMB; the annual growth rate of ordinary shares is 12%, the expected annual dividends is 2RMB, then,

\[D_c = 2 \times (1+12%) = 2.24, \quad K_s = 2.24/56 + 12\% = 16\%
\]

The following, briefly, are the other two ways to calculate the opportunity costs:

\[
K_s = K_b + R_{PC}
\]

Ks: the cost of retained earnings
Kb: the cost of debt
R_{PC}: the risk premium required by shareholders whose risk is greater than the creditors

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**TABLE I. FINANCIAL MATRIX**

<table>
<thead>
<tr>
<th>Sources of finance</th>
<th>%</th>
<th>Applications</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retained earning</td>
<td>30%</td>
<td>Daily operating, like raw material, overheads</td>
</tr>
<tr>
<td>Leasing</td>
<td>30%</td>
<td>Rent the equipment for producing TCM</td>
</tr>
<tr>
<td>Government aid</td>
<td>40%</td>
<td>Daily operating, like raw material, overheads</td>
</tr>
</tbody>
</table>

**TABLE II. OPPORTUNITY COST MODEL**

<table>
<thead>
<tr>
<th>Items</th>
<th>Capital assets pricing model</th>
<th>Risk premium model</th>
</tr>
</thead>
<tbody>
<tr>
<td>Formula</td>
<td>K_s = \frac{R_e - R_f \beta (R_m - R_f)}</td>
<td>K_s = K_b + R_{PC}</td>
</tr>
<tr>
<td>Notes</td>
<td>K_s: the cost of retained earning</td>
<td>K_s: the cost of retained earning</td>
</tr>
<tr>
<td></td>
<td>R_f: risk-free rate</td>
<td>Kb: the cost of debt</td>
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<tr>
<td></td>
<td>\beta: beta coefficient of stock</td>
<td>R_{PC}: the risk premium required by shareholders whose risk is greater than the creditors</td>
</tr>
<tr>
<td></td>
<td>R_m: the necessary rate of return on average equity risk</td>
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</table>
If we choose this source of funds, the impact on the financial statements will be reflected in the balance sheet. Retained earnings refer to the internal accumulation of retained profits, including surplus reserve and undistributed profits, which are extracted or formed from the profits realized in previous years. Surplus reserve refers to the accumulated capital withdrawn from the net profit by an enterprise in accordance with relevant regulations. Undistributed profit refers to the profit retained in the enterprise after the net profit realized by the enterprise makes up the loss, withdraws the surplus reserve and distributes the profit to the investor, and the profit is retained in the enterprise in the balance of the calendar year [5]. The essence of retained earnings is to make additional investments with that money. Therefore, it will affect capital and reserves. The income statement is going to go down, the fixed assets and the current assets are going to go up, because the company is going to use that money to buy some machinery to make Chinese medicine, or to use that money to make products that become stocks. Of course, retained earnings can also be turned into cash. In other words, the decrease of retained earnings will be converted into the increase of residual earnings.

D. Retained earnings

The produce line of TCM would be costly, so to buy the machines to build the produce line is not worthwhile. Thus, the company can rent these to operate the producing. And that should be the finance leases, since the producing of TCM is a long-term program. Leasing is a form of rental. The finance leases are lease agreements between the user of the leased asset (the lessee) and a provider of finance (the lessor) for the main part of the asset’s expected useful life, if not its entire useful life.

There are advantages to using finance leases as a form of finance:

- Few limited items and quickly to get the finance
- Small risk of the equipment which is too old to eliminate
- The rental can deduct before tax, lighter burden of tax
- The rental is apportioned during the whole leasing time, reducing the burden of principal payments

There are however, disadvantages

- Higher cost of capital and the fixed rental cause a heavy burden on its payment
- The lessee can not share the residual value of the equipment

The cost of leasing is rental and overheads. Rent is the main cost of leasing. The lessor provide the equipment and the lessee apportion the rental during the leasing time for using the equipment [6]. Except the rental, overheads are also a part of the cost of the leasing. For instance, the NPC pay money to train the staff to use the equipment to produce the TCM, then the training fee is part of the overheads.

If we choose this source of finance, the impact on the financial statement will be showed in the profit and loss account. Finance leases calculate the rent according to the time how long does the lessee occupy the equipment. So the rent in the profit and loss account is increasing. Moreover, the direct cost of the finance leases is also increase, such as the stamp duty, commission and the fee during the negotiations or the fee of training. The lessee should count and draw the depreciation of fixed assets acquired under finance leases, so the depreciation is increasing. All in all, the expenses are increasing; therefore, the profit before taxation and retained profit for the year are both decreasing.

E. Government aid

Since the NPC is not only a public limited company, but also a state-owned company, the company can ask the government to provide some supports. The government aid has its own characteristics. It is free but conditional. The government provides the grants to enterprise freely, but that not means the government have the power to control the company. The company also does not need to provide services or transfer the assets to reimburse the grants.

Government grants may appear to be without cost. However there may well be opportunity costs associated with eligibility for a grant. Being based in a certain region, for example, may deprive a business of certain sales opportunity. There will also be certain administrative costs to cover applying for the grant and (probably) filling in form on a regular basis to reassure the grant=giving authority that the business is still eligible to receive it.

If we choose this source of finance, the impact on the financial statement will be showed in two ways: (1) In the balance sheet. The government aid can be marked into the equity of the balance sheet to increase the additional paid-in capital of the company. (2) In the profit and loss account. The government aid can be marked into the profit sheet as subsidize profit.

IV. REASONS FOR INVESTING

It’s relatively easy to open a mutual fund account online or by phone. There are numerous funds that meet any chosen financial objective. The funds vary in their investment goals: Different funds are designed to appeal to the different motives and goals of investors. Three of the most common objectives are financial stability, conservative growth, and aggressive growth.

A. Stability and Safety

Funds stressing safety seek only modest growth with little fluctuation in principal value regardless of economic conditions. They include money market mutual funds and other funds that preserve the fund holders’ capital and reliably pay current income. Typical assets of these funds include lower-risk corporate bonds, government bonds, and other similarly safe short-term securities that provide stable income from interest and dividends.
B. Conservative Capital Growth

Mutual funds that stress preservation of capital and current income, but also seek some capital appreciation, are called balanced funds. Typically, these funds hold a mixture of long-term municipal bonds, corporate bonds, and common stocks with good dividend-paying records for steady income. The common stocks offer potential for market appreciation (higher market value), though there is always the risk of price declines if the general stock market falls.

C. Aggressive Growth

Aggressive growth funds seek maximum long-term capital growth. They sacrifice current income and safety by investing in stocks of new (and even troubled) companies, firms developing new products and technologies, and other higher-risk securities. They are designed for investors who can accept the risk of loss inherent in common stock investing with severe price fluctuations, but also the potential for superior returns over time.

V. CONCLUSIONS

When all the factors are examined, we may safely come to the conclusion that the choices of sources of finance should be based on the two principles: From the inside to the outside and minimize the debt. Thus, from the actual situation of the NPC, three appropriate sources of finance can be chosen to accumulate the funds for the TCM program. They are retained earnings, leasing and government aid. These sources of finance are from the inside to the outside and all of them are no borrowings which can minimize the debt. At the same time, the implication of the chosen sources of finance, especially the impact on the Annual Reports and Accounts (P&L account, balance sheet), should be analyzed to see whether these sources of finance can achieve the company’s benefits so that the company can seek the profit maximization. Finally, the finance resources management should be based on the actual situation of the company.

REFERENCES